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IN THE

Supreme Court of the United States

October Term, 1977

Nos. 77-10, 77-11, 77-12,
77-47, and 77-84

EXXON CORPORATION and PHILLIPS PETROLEUM COMPANY,
SHELL OIL COMPANY,
CONTINENTAL OIL COMPANY and KAYO OIL COMPANY,
GULF OIL CORPORATION,
ASHLAND OIL, INC., COMMONWEALTH OIL REFINING COMPANY, INC., and PETROLEUM MARKETING CORPORATION,

Appellants,

v.

GOVERNOR OF THE STATE OF MARYLAND, *et al.*,

Appellees.

ON APPEAL FROM THE
COURT OF APPEALS OF MARYLAND

REPLY OF APPELLANTS ASHLAND OIL, INC., COMMONWEALTH OIL REFINING COMPANY, INC., and PETROLEUM MARKETING CORPORATION

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This Reply is submitted by Appellants Ashland Oil, Inc. ("Ashland"), Commonwealth Oil Refining Company, Inc. ("Commonwealth") and Petroleum Marketing Corporation ("PMC"). Ashland and Commonwealth-PMC have appealed only that portion of the decision below which held that Paragraphs B and C of the Maryland Act did not violate the Commerce Clause. The argument in this Reply, therefore, is limited to that subject.

The basic standards to be applied in determining whether state legislation violates the Commerce Clause are not in dispute. The parties agree that the general rule is stated in *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970):

> Where the statute regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits. If a legitimate local purpose is found, then the question becomes one of degree. And the extent of the burden that will be tolerated will of course depend on the nature of the local interest involved, and on whether it could be promoted as well with a lesser impact on interstate activities. [citation omitted]

The question before the Court, as always, is whether the particular statute at issue meets this test.

The Maryland Act prohibits refiners from operating retail service stations with company personnel, and expressly provides that all such stations "must be operated by a retail service station dealer." The State contends this prohibition is an even-handed regulation that does not discriminate against interstate sellers in the Maryland market. It also says the Act is needed to preserve competition in the local retail gasoline industry, and asserts that this need outweighs any incidental burden on interstate commerce which may result from the statute's enforcement. These contentions cannot be squared with the record evidence. *Raymond Motor Transportation, Inc. v. Rice*, No. 76-558, slip op. at 15, 18 (Feb. 21, 1978).

1. THE MARYLAND ACT IMPOSES A SUBSTANTIAL BURDEN ON INTERSTATE COMMERCE

The State claims the Act does not unconstitutionally burden interstate commerce because "[i]nterference with the flow of gasoline across state lines, if any, is *de minimis* and permissible as an incident to the regulation of the retailing of gasoline." Appellees' Brief, p. 32. This erroneously assumes that no regulation of interstate business can violate the Commerce Clause unless it effectively reduces the total flow of goods coming into the State.

This Court has repeatedly made clear that interstate commerce may be burdened by means more subtle than direct restrictions on imports. Any state regulation having the practical effect of increasing operating costs, hampering efficiency, or otherwise reducing the competitive strength of interstate businesses can constitute a burden on commerce. *See, e.g., Hunt v. Washington State Apple Advertising Commission*, ____ U.S. ____, 97 S.Ct. 2434, 2445 (1977); *Great Atlantic & Pacific Tea Co. v. Cottrell*, 424 U.S. 366, 373-75 (1976); *Pike v. Bruce Church, Inc.*, 397 U.S. at 143-46; *H.P. Hood & Sons, Inc. v. DuMond*, 336 U.S. 525, 539 (1949); *Southern Pacific Co. v. Arizona*, 325 U.S. 761, 781-82 (1945). The fundamental question thus is not whether the total volume of goods moving in interstate commerce would be reduced, but rather whether the state has interfered "with the natural functioning of the interstate market *either* through prohibition *or through burdensome regulation.*" *Hughes v. Alexandria Scrap Corp.*, 426 U.S. 794, 806 (1976) (emphasis added).

The Maryland market is a small part of a much larger geographical market that is supplied by a number of refiners using various distribution methods.[1] Some — the major oil companies — market primarily through a dealer-

[1] The basic facts are not in dispute. See generally, Brief of Appellants Ashland Oil, Inc., *et al.* (hereinafter "Appellants' Brief"), pp. 7-12.

distribution system which uses service and brand recognition as its principal competitive tools. Others — the independent refiners — lack the resources for this type of marketing program and instead have chosen to rely upon company-operated "gas and go" outlets which sell private brand gasoline at discount prices.[2] The Maryland Act compels refiners that operate private brand stations either to install dealers at those locations or to abandon them. The State suggests that the drastic restructuring of distribution methods which the Act requires would neither significantly burden refiners which must conform to these requirements, nor otherwise disrupt the natural functioning of the retail gasoline market. Appellees' Brief, pp. 27-33. This astonishing conclusion is based on several subsidiary arguments, each of which is wholly at variance with the record.

First, the State argues that companies like Ashland, which has never used dealers to operate its private brand outlets, could nonetheless continue to participate in the retail market by converting to dealer operations. *Id.* at 30-31. This claim flies in the face of the unanimous testimony of all witnesses at the trial — including the

[2]All refiners, major or independent, need assured outlets for the sale of their production because refining is capital intensive and thus is not efficient unless plant capacities are fully utilized. The majors achieve this objective by sales to branded dealers, who represent a controlled market for their refinery production. Independents, on the other hand, sell primarily at wholesale to purchasers over whom they have no control, and thus are vulnerable to fluctuations in the price of crude oil supplies — over which they also have no control. The independents' response to this problem has been to acquire a limited number of direct retail sales outlets in order to balance demand during periods when market conditions temporarily force wholesale prices above competitive levels. These retail outlets provide an essential economic protection; their loss would seriously undermine the independents' competitive position in the national petroleum industry. See Appellants' Brief, pp. 9-12.

State's own expert. (A. 357, 450, 455, 503-04, 508, 517, 628). It is based on nothing more substantial than the assertion that two of the independents operating in the market (Hess and Crown) do in fact use dealers. However, the record is barren of any evidence which shows that these companies' contractual arrangements with their "dealers" are in compliance with the Act,[3] that the stations these "dealers" operate are comparable to the private brand outlets operated by Ashland, or that such stations are profitable.[4]

Second, the State speculates that, even if Ashland and similarly situated companies were forced to sell their private brand outlets, the impact of this loss "does not reach constitutional proportions" because marketers not affiliated with refiners might purchase these stations and continue to operate them with company personnel. Appellees' Brief, p. 31. There is, of course, no evidence that such buyers exist, or that independent marketers operating elsewhere would choose to invest in Maryland in sufficient numbers to replace the departing refiner-marketers. What

[3]The Act not only prohibits the use of salaried company personnel to operate refiner-owned service stations, but also proscribes operation by means of "commissioned agents," management contracts, and similar fee arrangements. Although the matter was not at issue before the trial court, there is reason to believe that the Hess and Crown "dealers" are actually "commissioned agents." (A. 460-61).

[4]The fact that Ashland might possibly continue to operate its stations with dealers, even if true, does not mean that compliance with the mandated change in distribution methods would not be burdensome. The private brand stations which Ashland operates depend for their economic viability upon high sales volumes, which in turn requires that prices be maintained at competitively low levels. This essential feature could no longer be assured if the stations were converted to dealer operations. (A. 357, 450, 455, 503-04, 508, 517, 628). The inevitable result of conversion, therefore, would be to raise prices and lower volumes, which would in turn reduce efficiency and undermine Ashland's competitive position in the retail market.

the record *does* show is that successful independent marketers tend eventually to integrate backward into refining as they grow in size and their needs for assured supplies increase. (A. 378-80, 427-29).[5] Consequently, even independent marketers would be discouraged from large-scale entry into Maryland because that decision would also require a decision to forego all future prospects for expansion into refining.

Finally, the State says this Court need not be concerned if companies such as Ashland no longer participate in the retail market, because they might still continue to sell their products at wholesale. Appellees' Brief, pp. 31-32. So they might, but only at increased costs due to loss of efficiency in overall operations.[6] Moreover, there is no reason to assume that Ashland or other similar companies would increase their *Maryland* wholesale sales to make up for the loss of retail sales; the most likely response would be to divert the gasoline to other markets where it could be more profitably sold. (A. 508). The suggestion that other refiners — notably the major oil companies — would take the independents' place in the *wholesale market* ignores the historic position of independent refiners as the principal source of wholesale supply for non-integrated retailers. (A.

[5]A recent example is Hudson Oil Company, which acquired a refinery subsequent to the trial. Hudson's owner testified she would give up her Maryland stations rather than abandon her refinery acquisition plans. (A. 518-19).

[6]Ashland's witness testified that loss of the retail stations could jeopardize its Maryland wholesale operations because it can supply this market only by means of an exchange agreement, and it could not meet is obligations under this agreement if the retail stations were not available to balance fluctuations in wholesale sales. (A. 509-10). After the Jurisdictional Statements were filed, PMC sold its Maryland stations to another refiner. Commonwealth hopes to continue wholesale operations in Maryland, but its witness testified he doubted the company could "even remain in the harbor" as a wholesaler because loss of the retail stations would reduce total volume by 60 to 75 per cent. (A. 463).

509, 623-24). There is no evidence whatever that the majors would increase supplies to the wholesale market if independent refiners were discouraged from sending their products into Maryland. The major oil companies have no incentive to increase supplies to independent marketers that compete with their own dealers; it is more reasonable to expect that they will increase sales through their dealer-operated stations if the independents' retail sales decline.

The record demonstrates that the Act creates positive disincentives for certain firms to do business in the State, and positive incentives for others to withdraw. (A. 383). Even if this does not reduce the total volume of gasoline transported into Maryland, it will surely change the market structure by weakening the independent refiners that supply it at retail and wholesale and by discouraging potential entrants at both levels of distribution. The likely result will be fewer — not more — private brand stations (A. 533-34), and higher — not lower — retail prices (A. 501-05, 531-32). To suggest that this does not burden interstate commerce in a constitutionally meaningful way is to ignore reality.

2. THE MARYLAND ACT DISCRIMINATES AGAINST INTERSTATE COMMERCE

The State argues that the Act does not discriminate against interstate commerce because "the statute accords even-handed treatment on its face *to all producers and refiners of petroleum.*" Appellees' Brief, p. 23 (emphasis added). This is true, but irrelevant. The Act does not and could not regulate crude oil production or refining, because all such activities take place wholly outside the State. What the Act regulates is *gasoline retailing*. And it does so in a manner which plainly discriminates against out-of-state retailers to the benefit of their local competitors.

The Maryland Act prohibits refiners from engaging in the direct retail sale of gasoline within the State, and reserves

this trade exclusively for dealers, wholesalers and other marketers not affiliated with refiners. The dealers are local residents of the State (A. 755), as are most of the wholesalers. (A. 569). The refiner-marketers are all out-of-state businesses. The statute thus prohibits an entire class of out-of-state merchants from continuing to sell at retail, while the local sellers with which they compete are left unaffected. To say that this result does not discriminate against interstate sellers stretches credulity past the breaking point.

The State correctly observes that some out-of-state businesses which are not affiliated with refiners may continue to operate retail service stations with company employees. Appellees' Brief, p. 24. This, however, does not save the statute. The law does not insulate state legislation from the sweep of the Commerce Clause merely because some local businesses are equally affected by its terms, *Dean Milk Co. v. City of Madison*, 340 U.S. 350, 354 (1951); *Nippert v. City of Richmond*, 327 U.S. 416, 431 (1946); nor should it do so simply because a few interstate businesses are not affected.[7] The issue, as always, is whether the economic impact of the state law "will in its practical operation work discrimination against interstate commerce." *Best & Co. v. Maxwell*, 311 U.S. 454, 456 (1940).

The vast majority of retail gasoline outlets in Maryland are conventional major brand service stations operated by independent dealers. The most significant source of price competition for these dealer-operated stations is provided by a relative handful of limited-service "gas and go" outlets selling private brands of gasoline at discount prices. More than half of these private brand stations are operated by refiners using company personnel. If the Act is sustained,

[7]As of July 1, 1974, companies not affiliated with refiners operated only 36 of the 233 company-operated retail outlets in the State. The remaining 197 were operated by refiners. See Appellants' Brief, p. 8 n.9.

these refiner-operated private brand stations must either be converted to dealer-operations—with a resulting loss of efficiency and competitive vigor, sold to eligible marketers — if buyers can be found, or closed. The direct, obvious and undeniable effect of the Act will be to eliminate at least some private brand stations and to reduce the effectiveness of those that remain. The Act also discourages entry of new suppliers, which further weakens the private brand segment of the market.[8] This result, which benefits only local dealers and wholesalers at the expense of their interstate competitors, is plainly discriminatory.

The State asserts that the Act's purpose was not to discriminate, but rather to deny "producers the power to focus windfall profits obtained from crude prices" and to assure that "gasoline will flow in the wholesale market to the truly independent marketer." Appellees' Brief, p. 33. This, however, is a *post hoc* rationalization developed after the State realized the Act could not easily be defended as a dealer protection measure.[9]

The legislative history contains no indication whatever that the Act was intended to benefit independent marketers.[10] What it shows instead is that the Act was pushed through the Legislature at the insistence of local dealers, who claimed they were the victims of a "sinister threat of the major oil companies" to replace them "with a limited number of company-operated 'Gas & Go' outlets which sell gasoline only with no service to the motorist." (A. 756, 758). The focus of the dealers' complaints was on

[8]The effects of the Act are discussed in Appellants' Brief at 15-17.

[9]The State was more candid at the inception of this litigation, and admitted in its answers to the appellants' bills of complaint that the Act was designed to preserve the "economic welfare and continuing existence of retail service station dealers." (A. 145; see also, A. 29, 51, 77, 104, 128).

[10]This history is described in Appellants' Brief at 32-36.

alleged unfair practices by their major oil company suppliers, but the relief they sought applied to *all* refiners — including those which have no dealers. The legislation they supported would also have prohibited wholesalers from engaging in direct retailing, but these "local businessmen" objected and were amended out. (A. 568, 569; J.A. 131a). The obvious purpose of the Act was to protect dealers from competition by whatever means the Legislature could be persuaded to adopt. It is difficult to conceive of a clearer example of the use of "local political power" to discriminate against interstate interests. *See Nippert v. City of Richmond*, 327 U.S. at 434; *Raymond Motor Transportation, Inc. v. Rice*, No. 76-558, slip op. at 14 n. 18, 17-18 (Feb. 21, 1978).

The State's final argument is that the Act cannot be discriminatory because it does not "prohibit or curtail the flow of interstate goods." Appellees' Brief, p. 25.[11] It asserts that this distinction is "controlling" in cases where state regulations are challenged as discriminatory. *Id.* However, the cases cited for this proposition do not support it.

In *Panhandle Eastern Pipe Line Co. v. Michigan Public Service Commission*, 341 U.S. 329 (1951), this Court held that an interstate gas transmission company could be prohibited from making direct sales to industrial customers unless it first obtained a certificate of public convenience and necessity from the Michigan Public Service Commission. The decision rested on the reasonableness of requiring the interstate seller to comply with the same certification procedures as applied to all sellers in the regulated market, not on the fact that it might have continued to sell the same amount of gas by routing it through a local utility. The Maryland Act, by contrast, absolutely prohibits refiners from participating in gasoline retailing

[11]The error of this view, as it applies to burdens on interstate commerce, has already been exposed. See p. 3, *supra*.

in *any* circumstance. This protects local dealers from competition by interstate refiner-marketers, and therefore works a practical discrimination against interstate commerce.

Breard v. Alexandria, 341 U.S. 329 (1951), also cited by the State, is similarly inapposite. *Breard* held that a local ordinance prohibiting door-to-door solicitors did not violate the Commerce Clause, even though its acknowledged effect was to benefit local merchants at the expense of companies relying primarily on travelling salesmen. In so holding, the Court observed that the complainants could still sell their products by means other than door-to-door solicitation. *Id.* at 638. The decision does not, however, stand for the proposition that a restriction on interstate business activity cannot be discriminatory unless the regulation completely prohibits the interstate sellers from participating in the local market, but rather rests on the finding that the admittedly discriminatory ordinance was justified by an overriding state interest in preserving the "privacy and repose" of local citizens. *Id.* at 626. Whether the economic discrimination caused by the Maryland Act can be justified is not answered by a blind appeal to *Breard*, but must instead be evaluated in light of the local interests the Act purports to serve.

3. THE DISCRIMINATORY BURDENS IMPOSED BY THE MARYLAND ACT CANNOT BE JUSTIFIED BY ANY LEGITIMATE LOCAL INTEREST

The *Bruce Church* balancing test contemplates an initial assessment of the practical effects of state regulation to determine whether the regulation substantially burdens interstate commerce or otherwise discriminates against it. If the regulation burdens (but does not discriminate against)

interstate commerce, the Court will sustain it unless the burden imposed "is clearly excessive in relation to the putative local benefits." 397 U.S. at 142. To decide this question, the Court considers "the nature of the local interest involved, and . . . whether it could be promoted as well with a lesser impact on interstate activities." *Id.* If the regulation also discriminates against interstate commerce, the balance shifts and "the burden falls on the State to justify [the regulation] both in terms of the local benefits flowing from the statute and the unavailability of nondiscriminatory alternatives, adequate to preserve the local interests at stake." *Hunt v. Washington State Apple Advertising Commission*, 97 S.Ct. at 2446.

Although the State claims the Act should be sustained under the *Bruce Church* test, it makes no serious effort to identify the putative local interests the Act purports to serve, to explain how prohibiting refiners from operating retail gasoline outlets will promote these interests, or to demonstrate that these interests could not be as well achieved by less burdensome means. It simply asserts that Maryland has a "substantial" interest in preventing "forward vertical integration by oil companies into local retail marketing at the expense and detriment of independent businessmen." Appellees' Brief, p. 33. The question, however, is not whether the State *believes* "forward vertical integration" is an "evil," but whether participation by refiners in retailing is *in fact* so harmful that a total prohibition of this activity is justified. *Raymond Motor Transportation, Inc. v. Rice*, No. 76-558, slip op. at 15, 18 (Feb. 21, 1978).

The only reason the State offers for excluding refiners from retailing is a supposed need to halt "the recent trend of increased direct operation of service stations by producers and refiners" which, "if allowed to continue, could substantially decrease competition and lead to the control of that market by a few major oil companies."

Appellees' Brief, pp. 24-25.[12] This, however, refers to a supposed tendency of *major oil companies* to use more company-operated outlets in their retail operations. It says nothing whatever about independent refiners which do not use dealers, have never done so, and could not continue to compete at retail if they are prevented from using company outlets to distribute their products. Exclusion of these companies from the retail marketplace would not enhance competition, but would weaken it by removing the principal source of price competition to dealer-operated major brand service stations. The Act will not, as alleged, prevent "a few major oil companies" from taking over the retail market; its actual effect will be to eliminate the major oil companies' only substantial competitors.[13]

The State cannot offer a justification for excluding independent refiners from retail marketing, because none exists. "[T]he very purpose of the Commerce Clause was to create an area of free trade among the several States." *Great Atlantic & Pacific Tea Co. v. Cottrell*, 424 U.S. at

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[12]The State may have admitted more than it intended when it says in the very next sentence that "[t]he prevention of . . . destructive competition is a wholly appropriate legislative function . . . permissible under the Commerce Clause." Even if this is an accurate statement of the law, it is still incumbent on the State to explain why the competition provided by refiner-marketers is "destructive" and how "healthy" competition will be enhanced by excluding refiner-marketers from the market. The State's failure even to attempt an explanation speaks for itself.

[13]We do not contend that Maryland has no power to regulate gasoline retailing. We simply argue that the statute at issue here violates the Commerce Clause because the discriminatory burden which it imposes on independent refiner-marketers actually conflicts with the only interest the State claims the Act will serve. The State apparently believes some form of regulation is needed to protect "independent businessmen" from "destructive competition." However, it has not even considered whether less burdensome or less discriminatory legislation might serve that interest equally well. The absence of any such consideration is, we submit, decisive under the *Bruce Church* test.

370. The freedom which it protects "is a freedom to trade with any State, to engage in commerce across all state boundaries." *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318, 335 (1977). The unwarranted exclusion of independent refiners from the Maryland retail market subverts this fundamental constitutional principle.

Respectfully submitted,

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